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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1967

No. 475

NATHANIEL C. WOOD AND GERTRUDE L. WOOD,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

PETTTION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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Petitioners pray that a writ of certiorari issue to review the judgment of the United States Circuit Court of Appeals for the Fifth Circuit in this case.

OPINION BELOW

The opinion of the United States Court of Appeals for the Fifth Circuit is reported at ..... F. 2d ..... (R. pp. 77-99*) and is reprinted in Appendix, *infra*, pp. A1-A21.

*References to "R" are to the certified transcript of the record.

JURISDICTION

The judgment of the United States Court of Appeals for the Fifth Circuit was entered on May 11, 1967. (R. 101). The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

QUESTION PRESENTED

Whether Petitioners retained an economic interest in sand and gravel under a contract permitting the removal of sand and gravel from their ranch, thereby precluding capital gains treatment of amounts received by Petitioners under the contract.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are Section 611 (a) of the Internal Revenue Code of 1954, 26 U.S.C. Section 611, and Treasury Regulations Section 1.611-1(b) and 26 C.F.R. Section 1.611-1(b).

STATEMENT OF THE CASE

The Petitioners, Nathaniel C. Wood and Gertrude L. Wood[1], brought this action for refund of Federal Income Taxes for the taxable years 1958, 1959 and 1960.

Mr. Wood, at all pertinent times herein, was engaged in the ranching business on 14,088 acres of land in Crosby County, Texas. Shortly after purchasing the ranch, Mr. Wood entered into a contract with Chancey-Dickey Materials Company, under which the company was permitted to remove sand and gravel from the ranch for a period of five years. Prior to the expiration of the five year term,

1. Mrs. Wood was made a party merely because a joint return was filed, and she had no active part in the business transaction involved herein.

Noble W. Prentice and his associates, hereinafter called "Prentice," who were in the sand and gravel business, approached Mr. Wood in an effort to reach some agreement whereby Prentice could gain absolute control and dominion over the sand and gravel deposits. (R. 49 and 50). Negotiations resulted in a contract dated November 22, 1954 and entitled "Sand, Gravel and Rock Lease," hereinafter called "contract". (R. pp. 8-13).

Upon the termination of the Chancey-Dickey Company contract, Janes-Prentice, Inc., to whom Prentice had assigned the contract, entered onto the ranch, installed equipment, buildings, roads, generating equipment, power lines, telephone lines, water reservoirs, and water circulating systems, and began sand and gravel operations under the contract. (R. 59).

The Petitioners reported payments received under the contract as ordinary income and took a 5% depletion deduction with respect to such payments. Subsequently, Petitioners requested the refunds, which are the basis of this action, on the grounds that payments received under the contract were capital gains rather than ordinary income.

The issue was tried before the District Court of the United States for the Northern District of Texas and judgment entered dismissing Petitioners' suit on the merits.

The Fifth Circuit affirmed the decision of the District Court in a decision entered May 11, 1967, on the grounds that the Petitioners retained an economic interest under the contract.

REASON FOR GRANTING THE WRIT

In determining that Petitioners retained an economic interest in sand and gravel under a contract permitting the removal of sand and gravel from their ranch, the Court of Appeals for the Fifth Circuit made an interpretation of "economic interest" that is in conflict with decisions of this Court and other Circuits.

This Court formulated the "economic interest" concept in the case of *Palmer* v. *Bender,* (1933) 287 U.S. 551. In that case, this Court held that a taxpayer has an economic interest where he has (1) acquired by investment any interest in the mineral in place, and (2) secured by legal relationship, income derived from the extraction of the mineral to which he must look for a return of capital.

The Regulations[2] adopt the two tests set forth in *Palmer* v. *Bender* as the controlling principles in determining whether or not a taxpayer has an economic interest. It is Petitioners' position that they do not meet the second test, and, therefore, do not have an economic interest in the sand and gravel.

This Court in *Commissioner* v. *Southwest Exploration Company,* (1956) 350 U.S. 308, in referring to the second test formulated in *Palmer* v. *Bender,* stated at page 314:

> "The second factor has been interpreted to mean that the taxpayer must look solely to the extraction of oil or gas for a return of his capital, and depletion has been denied where the payments were not dependent on production."

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2. Reg. § 1.611-1(b) *Economic Interest.* (1) Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits * * *. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place * * *, by any form of legal relationship, income derived from the extraction of the mineral * * *, to which he must look for a return of his capital.

The Court below in this case interpreted the term "production" in the above described second test, as meaning merely "extraction" or "removal of the mineral" but admitted that such interpretation is nowhere expressly stated by the Supreme Court. (Appendix, *infra* p. A10 and at fn. 16). A reading of the cases indicate that the Court's interpretation is an oversimplification of the term "production" and not in accord with the economic interest test as applied by this Court and other Circuits.

Where the retained interests are true royalty interests[3] this Court has consistently found that an economic interest has been retained. *Palmer* v. *Bender, supra; Commissioner* v. *Southwest Exploration Company, supra.* Likewise, where the retained interest was related to market values, this Court and Circuit Courts have found that an economic interest was retained. *Kirby Petroleum Co.* v. *Commissioner,* (1946) 326 U.S. 599; *Burton-Sutton Oil Company* v. *Commissioner,* (1946) 328 U.S. 25; *United States* v. *Witte,* (C.A. 5th, 1962) 306 F. 2d 81; *Hamme* v. *Commissioner,* (C.A. 4th, 1953) 209 F. 2d 29.

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3. Breeding & Burton, Income Taxation of Oil & Gas Production (Prentice-Hall, 1961 Ed.), § 2.01—defines a royalty interest for federal tax purposes, as "a right to oil and gas in place that entitles its owner to a specified fraction, in kind or in value, of the total production from the property, free of expense of development and operation." Clearly, the term "royalty" as used in the instant contract is a misnomer. A royalty interest has been defined by the Fifth Circuit as a right to receive a specified percentage of all the minerals produced during the entire term of the lease, and not limited to a specified sum of money. *United States* v. *Morgan,* (C.A. 5th 1963) 321 F. 2d 781, 785. Under the contract, the Petitioners are not entitled to a specified percentage of all the minerals produced during the entire term of the contract, rather they are limited to a fixed price per unit removed.

The term "lease" used in the contract is also a misnomer. In *United States* v. *Witte,* (C.A. 5th, 1962) 306 F. 2d 81, at fn. 10, page 86, the Fifth Circuit noted that the distinguishing element between a lease and a sale is whether any royalty interest is retained in the part sold. As defined above in *Morgan* case, the payments involved herein are not royalties within the meaning of that term, as used for Federal tax purposes.

Conversely, the Courts have found that an economic interest was not retained where the payments were not related solely to payments in kind or to market value of the minerals when produced. *Parsons* v. *Smith,* (1959) 359 U.S. 215; *Paragon Jewell Co.* v. *Commissioner,* (1965) 380 U.S. 624; *Barker* v. *Commissioner,* (C.A. 2nd, 1947) 250 F. 2d 195; *Crowell Land and Mineral Corporation* v. *Commissioner,* (C.A. 5th, 1957) 242 F. 2d 864; *Gowans* v. *Commissioner,* (C.A. 9th, 1957) 246 F. 2d 448; *Commissioner* v. *Remer,* (C.A. 8th, 1958) 260 F. 2d 337, *Linehan* v. *Commissioner,* (C.A. 1st, 1961) 297 F. 2d 276; *Turner* v. *United States,* (D.C. Maine, March 3, 1964) 226 F. Supp. 970; but see *Freund* v. *United States,* (C.A. 7th, 1966) 367 F. 2d 776; *Laudenslager* v. *Commissioner,* (C.A. 3rd, 1962) 305 F. 2d 686; *Rabiner* v. *Bacon,* (C.A. 8th, 1967) 373 F. 2d 537; and *Royalton Stone Corporation* v. *Commissioner,* (C.A. 2nd, 1967) ..... F. 2d .....; 19 A.F.T.R. 2d 1681.

In arriving at its interpretation that "production" under the economic interest concept is merely "extraction" the Court below did not take into consideration that a typical "hard mineral" contract does not fit into oil and gas rules and terminology. The Court below notes that the economic interest concept was formulated in oil and gas cases (Appendix, *infra* p. A6), but finds that there should be no difference in approach because of the nature of the mineral involved (Appendix, *infra* p. A6). Although the court below ostensibly applies the economic test as enunciated in *Palmer* v. *Bender* it refuses to get into the "subtleties and intricacies" of that test where a "typical" mineral lease is involved. (R. pp. 9 and 10). Since the Court finds that royalty payments in a "typical" hard mineral case are fixed amounts per unit removed, and admits that "a royalty determined by quantity removed is foreign to the field of oil and gas leases, the area in which the economic interest test originated," (Appendix *infra* p. A10) it is under-

standable why the Court cannot get into the subtleties of the economic interest test. The test applied by the Court below is not the economic interest test. The Court first found that there was, in the instant case, a "typical" lease, as compared, for example, with the lease in *Douglas* v. *Commissioner*, (1944) 322 U.S. 275, and from such finding the Court concluded there was a retention of an economic interest. (Appendix, *infra* pp. A9 and A10).

The same confusion, with respect to oil and gas royalties and the so-called "royalty" in this and other hard mineral cases, carries over to the Circuit Court's treatment of "minimum guaranteed royalty." (Appendix, *infra* p. A11).

Further, the Court rejects the argument that the contract totally divested Mr. Wood of all economic interest in the sand and gravel and points to two provisions of the contract but declined "to develop at length the rationale behind the economic interest test" (Appendix, *infra* p. A12 and fn. 19). One of the two paragraphs, paragraph 5, of the contract (R. pp. 10 & 11), pertaining to the reduction of royalty payments in time of national calamity, is not such a provision as would cause an economic interest to be retained. In Rev. Rule. 62-81, 1962-1 CB 153, the owner of a tract of timber land entered into a contract whereby the operator was obligated to make minimum payments regardless of whether any timber was cut, and provision was also made whereby the minimum payment could be reduced where operation was prevented by specified factors beyond the control of the parties. Concerning such reduction, the Government stated at p. 155: "The possibility of a reduction of the purchaser's obligation to pay, to the extent that performance is prevented by specified factors other than fire does not create a retained economic interest in the timber; despite such possibility, the landowner still

looks to payments which are not conditioned upon the severance of timber for the recovery of his investment." This is precisely Petitioners' argument.

Likewise, when closely examined, there is nothing in the other paragraph of the contract noted by the Court below, i.e. Paragraph (4) (R. p. 10), that would cause an economic interest to be retained. Paragraph (4) clearly shows that the minimum annual payments may be made from sales *"and/or supplemental payment."* Thus, payments are not dependent solely upon the extraction and sale of sand and gravel.

In this case the payments are fixed at twenty-five cents per cubic yard, regardless of whether the market price is fifty cents or five dollars per cubic yard. (R. p. 10). Further, despite the fact that the payments are termed "royalties" the contract cannot be interpreted as allocating any share of production to Petitioners. Janes-Prentice, Inc., owns the entire production of sand and gravel from the ranch.[4]

Although payments under the contract are twenty-five cents per cubic yard of sand and gravel removed, a minimum payment of $15,000.00 is to be made annually regardless of whether any sand, gravel and rock is produced, or whether the amount produced is less than 60,000 cubic yards. In the event the $15,000.00 minimum is paid in a year when less than 60,000 cubic yards is removed, the difference can be recouped in a subsequent year in which more than 60,000 cubic yards was removed. (R. p. 10). However, there is no provision for recoupment in the event subsequent production does not exceed 60,000 cubic yards. Thus, Petitioners' payments are not solely from production,

4. Janes-Prentice, Inc. has "sole and exclusive right and privilege of mining, removing and disposing of as desired, sand, gravel and rock" from the entire ranch. (R. p. 8). The contract stipulates that all processed sand, gravel and rock remains the property of Janes-Prentice, Inc., until removed from the premises. (R. p. 13).

but are simply measured by production. The bare right to payments measured by production do not result in the retention of an economic interest. *Commissioner* v. *Remer*, (C.A. 8th, 1958) 260 F. 2d 337 at 339.

The economic substance or reality of the contract is that Petitioners actually surrendered their capital interest in the sand and gravel by absolutely relinquishing all economic dominion and control over all the sand and gravel on the entire 14,088 acres of the ranch. The facts abundantly support such conclusion:

1. Petitioners cannot terminate the contract at will or without cause.

2. With respect to the sand and gravel in place: Petitioners cannot mine, sell or keep any sand and gravel; Petitioners cannot compel Janes-Prentice, Inc. to mine any sand and gravel[5]; and Petitioners cannot prevent Janes-Prentice, Inc. from mining the sand and gravel to exhaustion.

3. With respect to mined sand and gravel: Janes-Prentice, Inc. has "sole and exclusive right and privilege of mining, removing and disposing of as desired, sand, gravel and rock" from the entire ranch (R. p. 8); ownership of mined sand and gravel remains in Janes-Prentice, Inc.[6]; and Petitioners are not entitled to share in production.

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5. The Court below noted that this is probably an incorrect statement in that the habendum clause is the same as in an oil and gas lease and under Texas laws, such a clause gives rise to an implied covenant to produce. (Appendix, *infra* fn. 19 p. A12). Again, this demonstrates the Court's confusion between a hard mineral lease, which generally has a minimum payments clause, and an oil and gas lease where ordinarily a royalty is retained and production is the sole source of payments.

6. The contract stipulates that all processed sand and gravel and rock *remains* the property of Janes-Prentice, Inc., until removal from the premises. (R. p. 13).

4. Payments to Petitioners for sand and gravel removed are fixed, and do not relate to sales price, value, or profits.

5. After sand and gravel is removed, the land is worthless for ranching, farming or any known purpose.

Although factors outlined above, demonstrating Petitioner's lack of control, have been accorded various weights by different courts many of the foregoing factors were considered favorably to the Petitioners' position herein. See *Helvering* v. *Bankline Oil Co.*, (1938) 303 U.S. 362; *Parsons* v. *Smith*, (1959) 359 U.S. 215; *Elm Development Co.* v. *Commissioner*, (C.A. 4th, 1913) 315 F. 2d 488; and Sneed, *The Economic Interest—an Expanding Concept*, 35 Texas Law Review 309 at 341-344 (1957).

Mr. Wood testified that the mining of sand and gravel down to the red beds leaves the land worthless for ranching, farming or any known purpose. (R. p. 36). Therefore, the practical economic substance of a contract under which the sand and gravel can be mined to exhaustion, and when mined, leaves the land worthless, has aspects of sale rather than lease. Courts have considered the worthlessness of the land an important factor indicative of a sale of soil rather than a lease. *Dann* v. *Commissioner*, (1958) 30 TC 499 at 503 and 505; *Brown* v. *United States*, (D.C. E.D. Ark. 1966) 17 A.F.T.R. 2d 229.

The economic reasons for holding there is a sale rather than a lease in sand and gravel cases are much more persuasive than in the case of fugacious minerals and timber. This is not only because such natural resources may be replenished from surrounding lands (oil and gas), see *United States* v. *Ludey*, (1927) 274 U.S. 295; or may be recharged (underground water), see *M. C. Puckett*, (C.A. 5th, 1966) 355 F. 2d 551; or may regrow (timber), see *Dyal* v. *United States*, (C.A. 5th, 1965) 342 F. 2d 248; but principally be-

came the surface of the land after the removal of such minerals and timber is not thereby rendered worthless for any known purpose.

Thus, the Petitioners can neither be identified as "the party to whom benefits and burdens attendant to mineral production are to be attributed" nor is Petitioners' interest dependent "solely upon the extraction and sale" of the sand and gravel. *Weinert's Estate* v. *Commissioner,* (C.A. 5th, 1961) 294 F. 2d 750 at 755.

It follows that the economic substance of the contract is that Petitioners have transferred their capital interest in the sand and gravel on their ranch, and have retained no economic interest therein. Accordingly, the transaction was a sale and the Petitioners are entitled to capital gains treatment of amounts received under the contract in the taxable years 1958, 1959 and 1960.

The Circuit Court's interpretation and application of the economic interest concept to the facts of this case are in direct conflict with this Court's decisions in *Palmer* v. *Bender, supra,* with the First Circuit in *Linehan* v. *Commissioner, supra,* and with the Ninth Circuit in *Gowans* v. *Commissioner, supra.*

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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